

Types of Bank Supervision

Bank supervision is a supervisory function charged with the responsibility of ensuring the safety and soundness of the banking system as a whole. Books and affairs of every licensed insured institution are examined as a means of meeting its supervisory mandate.

This function is performed through the off-site surveillance and on-site examination of the books and affairs of the banks, which exceptions are reported and recommendations made on how the observed lapses can be corrected, and the implementation of such recommendations is monitored through scheduled post examination visits to the affected banks. While on the other hand Regulation involves providing input into developing and interpreting legislation and regulations, issuing guidelines, and approving requests from regulated financial institutions.

The three main types of supervision are Transaction Based, Consolidated and Risk Based Supervision.

- **Transaction's Based Type of Supervision:** This supervisory approach focuses on individual group entities. Individual entities are supervised on a solo basis according to the capital requirements of their respective regulators. The Transaction's Based Type of Supervision of individual entities is complemented by a general qualitative assessment of the group as a whole and, usually, by a quantitative group-wide assessment of the adequacy of capital.
- **Consolidated supervision:** This is a group-wide approach to supervision whereby all the risks undertaken by a group of companies are taken into account in the supervisory process. This will entail the identification of the risks to which the components of the group are exposed to and the impact of such risks on the group operational activities. Consolidated supervision entails the process whereby the supervisor can satisfy himself about the health of the entire group's activities which may include bank and non-bank companies, financial affiliates as well as branches and subsidiary companies.

Consolidated supervision has the following objectives:

1. To support the principle that no banking activity, and the associated risk no matter where located, escapes supervision.
2. To prevent over-leveraging of capital- double counting
3. To evaluate the strength of a group to which a licensed bank belongs, in order to assess the potential impact of other members of the group on the licensed bank.

4. To consolidate the financial returns i.e. consolidation of accounts of the licensed entity using quantitative approach, while ensuring that the qualitative approach evaluates the material risks on the financial position of the licensed bank.

Consolidated supervision will entail the following:

- Adequate knowledge of the structure of a group and the risks there in;
- Adequacy or otherwise of capital measured on a group basis;
- Measurement of larger exposures on a group basis.

Consolidated supervision should not be seen as a substitute for the supervision of individual bank, but rather be regarded as being complementary. There is the need for the various supervisory agencies to cooperate to ensure that the group financial activities are comprehensively supervised taking into consideration various risks that could affect the health of the individual entities and the group.

In “Consolidated Supervision; Managing the Risks in a Diversified Financial Services Industry” (June, 2001) by the International Monetary Fund (IMF) the following practices were recommended:

1. Consolidated Supervision must be a complement to, not a substitute for solo supervision.
2. Consolidated Supervision could be quantitative or qualitative depending on the nature of particular assets and activities conducted in other parts of a group.
3. Methods of consolidation could be:
 - full line-by line
 - equity method
 - proportional consolidation using relevant I.A.S. (27, 28, 31, 25 and 39)
4. Consolidated Supervision program should be designed
5. Creation of Consolidated Supervision minimum standards
6. Establishing Consolidated Supervision co-operation between home and host supervisors.

Consolidated Supervision can take the following forms:

1. Quantitative Consolidated Supervision (QCS)
This is based on consolidated returns, reflecting an accounting consolidation of the parent bank with parts or the whole group to which it belongs. When conducting QCS, specific capital ratios at both the sole and consolidated levels

are set, against which the parent bank and the group are monitored. Large exposures and connected lending are also monitored and controlled on both solo and consolidated basis.

2. Qualitative Consolidated Supervision

Where accounting consolidation is not meaningful, because of the nature of particular assets and activities conducted in other parts of the group (e.g. where an industrial or insurance company is involved), a qualitative consolidated supervision should be undertaken. The supervisor will focus on the group's general business and the environment, in which it operates, as well as its controls, organization and management in order to evaluate material risks to the reputation or financial soundness of the parent bank.

3. Accounting Consolidation

The relationship of authority will require prudential returns reflecting consolidated financial statements for the parent bank together with all relevant financial companies within the group. The supervisor should adopt the full line by line consolidation technique. This involves the consolidation of all entities within the group, covering all the assets and liabilities, according to conventional accounting standards including the netting off of balances between companies. The relevant international Accounting Standards (IAS), such as IAS 27 on subsidiaries, IAS28 on associates, IAS31 and 25 on joint ventures and investments respectively, should be considered in carrying out this process.

- **Risk Based Supervision:** The dynamism of the global economic environment requires more robust tools and skills to mitigate risks arising from the rapid development of the financial sector. In response to the changing financial landscape, advancement in, and widespread use of information/communications technology, a more effective approach is required. Although effective risk management has always been central to safe and sound banking activities, it has assumed added importance for two main reasons. Firstly, new technologies, product innovation, size and speed of financial transactions have changed the nature of banking. Secondly, there is need to comply fully with the Basel Core Principles on Supervision and to prepare an enabling environment for the implementation of the New Capital Accord.

The foregoing, amongst others, premised the imperative of the adoption of RBS Framework.

RBS is a robust, proactive and sophisticated supervisory process, essentially based on risk profiling of a bank. It enables the supervisor to prioritize efforts and focus on significant risks by channeling available resources to banks that have high-risk profiles.

RBS assesses the efficacy of a bank's ability to identify, measure, monitor and control risks. It designs a customized supervisory programme for each bank and focuses more attention on banks that are considered to have potentially high systemic impact.

By the very nature of banking business, banks are inextricably involved in risk-taking. The major risks banks face in the course of business include, but not limited to, credit, market, liquidity, operational, legal and reputational risks. In practice, a bank's business activities present various combinations of these risks, depending on the nature and scope of the particular activity. To the financial sector regulatory and supervisory authorities, what constitute risks are those factors that pose threat or portend danger to the achievement of statutory objectives.

In Nigeria, these objectives include the promotion of a stable, safe and sound financial system, ensuring an efficient payment system, necessary for the achievement of the wider economic objective of welfare improvement, ensuring effective consumer protection and the reduction of financial crimes, among others.

RBS presents a framework with which banks are assessed regarding the probability and impact of risks as opposed to the intuitive assessment by the traditional approach. In contrast to the traditional form of supervision which is biased in favour of risk-avoidance and hence against innovative products and services, risk-based supervision treats risks mitigating and offsetting as valid approaches to risk management.

A risk-focused supervisory process provides flexible and responsive supervision to foster consistency, coordination as well as communication among supervisors, relies on the understanding of the institution, the performance of the risk assessment as well as the development of a supervisory plan and procedures tailored to the risk profile of individual institutions. In that regard, risk-based supervision identifies, measures and controls risks; and monitors the risk management process put in place by a financial institution during a supervisory period.

1. The main objective of risk-based supervision is to sharpen supervisory focus on: the activity(ies) or institution(s) that pose the greatest risk to banks and financial institutions and/or financial system; and
2. The assessment of management process to identify, measure, monitor and control risks.

The main benefits of this approach to supervision include, amongst others:

1. The allocation of supervisory resources according to perceived risk, i.e. focusing resources on the bank's highest risk or devoting more supervisory efforts to those banks that have a high-risk profile. It will, therefore, enable the regulator to target and prioritize the use of available resources.
2. The supervisor will be better placed to decide on the intensity of future supervision and the amount and focus of supervisory action in accordance with the perceived risk profile of the bank.
3. The supervisor may also focus more attention on banks whose failure could precipitate systemic crisis.